ASC TOPIC 606

REVENUE RECOGNITION

It's Here. Now What?

By Nancy Rix, Mark F. Wille and Mark Dauberman

It took more than 11 years for the Financial Accounting Standards Board and the International Accounting Standards Board to develop a converged standard for revenue recognition, which first appeared on the boards' technical agendas in 2002. Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers* (ASC Topic 606) was issued on May 28, 2014.

And by now, you've likely read about the new, five-step process and know that the standard soon will be effective. You've also likely heard the warnings of the "many implications," "changing business model" or "full transformation" that will be required to be compliant. Much of this is true and, as such, it's time to start considering how this is going to impact the small-firm practitioner—including the impact of the principles nature of this standard, the transition methods and what the new standard will mean for certain industries.

Principles-based Approach

While the idea of a principles-based approach to U.S. standard setting is not new, ASC Topic 606 may be the most striking and significant example to date of the FASB's willingness to promulgate new guidelines using this approach, rather than the rules-based method. The FASB has used its conceptual framework—a principles-based methodology—for more than 30 years in developing new accounting standards, but beginning in the early to mid 2000s, critics began asserting that standards were becoming increasingly detailed and rules-based, complex, difficult and costly to apply. Examples of financial engineering to structure transactions around the rules began to emerge.

Under a principles-based approach, new standards are applied more broadly and are more general, providing few bright lines and mandates. In theory, standard-setting bodies such as the FASB provide less interpretive and implementation guidance, which requires firms to prepare analyses and make extensive and critical judgments regarding measurement, recognition and disclosure issues. The FASB has commented that any guidance issued should focus "only on significant matters addressed in the standards, thereby increasing the need to apply professional judgment in the situations not addressed."

Now that we understand that applying the standard will involve significant judgment, with possibly a few specific prescriptions, let's review the five-step process.

1. Determine Whether You Have a Contract

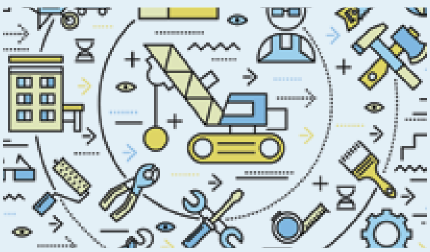
To determine if there is an actual contract, consider if the agreement:

- Is approved and the parties have committed either orally or in writing;
- Identifies the rights and responsibilities of the parties;
- Has payment terms, though it's sufficient that if the specific amount is not included in the contracts it can easily be estimated;
- Has commercial substance; and
- Collectability is probable.

Using these factors to determine whether a contract exists will be a threshold issue. There is no need to apply this standard where there is no contract.

WHAT ASC TOPIC 606 MEANS FOR...

The Engineering & Construction Industries



A significant difference for construction accounting will result from change orders and modifications. Modifications will need to be evaluated within the context of whether it represents a separate contract—for example, whether all rights and responsibilities are delineated and whether or not the parties approved the new contract, either orally or in writing. If a separate contract does not exist, the accounting for the modification may be done in one of three ways:

1. Termination of the existing contract and creation of a new one;
2. Treated as if the changes were part of an existing contract; or
3. A combination of nos. 1 and 2.

What this means is that should the contractor begin work on the modification prior to establishment of enforceable rights and obligations, no profit will be recognized on that work until the modification is approved. Of course, as discussed previously, this could also give rise to significant book/tax differences.

In addition, construction clients also may see differences from current accounting for mobilization costs and loss contingencies, and for accounting for the costs of obtaining a contract, such as bonding costs. Other identified implementation issues with guidance either already provided or forthcoming include:

- **Identifying the Unit of Account (including combining contracts, loss of segmentation guidance, options, separate performance obligations):** This implementation issue will discuss how to determine the unit of account for recognition of revenue and margin for engineering and construction contracts, including combining of contracts, segmenting of contracts, and identifying performance obligations. **Status:** Finalized (included in the 2017 AICPA *Audit and Accounting Guide: Revenue Recognition*).
- **Variable Consideration and Estimation Methods (including claims, change orders (un-priced and unapproved), incentives, penalties, extras, liquidated damages, back charges, collectability):** This issue deals with the factors used in estimating the amount of variable consideration to which an entity will be entitled, and how an entity should determine the amount of estimated variable consideration to include in the transaction price. For example, un-priced change orders give rise to variable consideration. This issue also involves the types of constraints to be considered when recognizing variable consideration. See also the specific examples in the codification dealing with contract modifications and unapproved change orders in FASB ASC 606-10-55-111 to 55-116 and FASB ASC 606-10-55-134 to 55-135. **Status:** Finalized (included in the 2017 AICPA *Audit and Accounting Guide: Revenue Recognition*).
- **Acceptable Measures of Progress, Accounting for Service Contracts, and Wasted Materials:** This implementation issue involves acceptable measures of progress, i.e. the acceptable use of the cost-to-cost method for performance obligations satisfied over time. **Status:** *Finalized* (included in the 2017 AICPA *Audit and Accounting Guide: Revenue Recognition*).
- **Uninstalled Materials:** Depending on the contract, uninstalled materials may be considered an input variable used when considering progress toward completion of the job. This means that uninstalled materials can be included in revenue in certain circumstances. The issue involves whether the determination of uninstalled materials as an input variable is only required at the onset of the contract; whether the model applies to both inventoriable and non-inventoriable, such as highly customized materials; and how to account for such materials when installed. **Status:** Out for exposure.
- **Impact of Termination for Convenience on Contract Duration:** This question involves the impact of customer termination rights and penalties on contract terms. **Status:** Out for exposure.
- **Contract Costs:** This involves clarifying the accounting for pre-contract costs and all other costs that qualify for capitalization. Note that under the new standard, the incremental costs of obtaining a contract, such as bonding costs, must be capitalized and amortized on a systematic basis. **Status:** Out for exposure.
- **Disclosures:** This deals with clarifications of disclosure requirements. Under ASC Topic 606, disclosures are intended to provide both qualitative and quantitative information about contracts and the corresponding significant judgments applied, as well as the assets recognized from costs to fulfill a contract. An area of discussion includes required disclosures related to incomplete performance obligations—including the required actions, timing and expenses necessary to satisfy the performance obligation. **Status**: Out for exposure.

WHAT ASC TOPIC 606 MEANS FOR...

Nonprofit Entities

Accounting and financial reporting for many nonprofit entities is undergoing significant change. As this article was being written, the FASB has issued an exposure draft covering accounting for grants and contributions expected to have enormous impact on the industry.

Remember that nonprofit entities *are* included within the scope of this standard even though contribution revenue largely is not. More specifically, exchange revenue from sources as membership fees, sales of products and services, naming rights, sponsorships and special events is included under the new standard. So, the delineation of transactions between exchange (covered under new revenue recognition rules) and contributions (covered under new industry guidance) is expected to be challenging. Further difficulties will be presented by transactions including elements of both exchanges and contributions.
Other specific issues include:

- **Tuition and Housing Revenue for Higher Education Institutions:** This issue involves determining the transaction price and how to recognize revenue for tuition and housing over time. **Status:** Finalized (included in the 2017 AICPA *Audit and Accounting Guide: Revenue Recognition*).
- **Subscription and Membership Dues:** This issue deals with how nonprofit organizations should account for membership dues, subscription revenue and lifetime subscriptions. **Status:** Finalized (included in the 2017 AICPA *Audit and Accounting Guide: Revenue Recognition*).

2. Identify the Performance Obligations

Now that you have a contract, it's time to identify what the standard refers to as the "performance obligation."

Under the new standard, you'll need to separate each performance obligation into distinct pieces or bundles. If a customer can use or benefit from an individual good or service on its own, or with other readily available resources, that specific performance obligation is considered distinct. However, if a good or service is dependent on, or highly interrelated with, other items promised in the contract, that piece alone cannot be considered distinct.

3. Determine the Transaction Price

The new standard provides several considerations when determining transaction price:

- **Variable consideration**: Estimate what you will receive in exchange for the goods or services provided, taking into account such factors as discounts, rebates, refunds and other similar items. Historical and forecast data should also be considered when estimating consideration.
- **Constraining estimates of variable consideration**: Consider constraining events when estimating the amount of variable consideration that should be included in the transaction price. Even things outside of the entity's control should be included. After each reporting period, the estimate should be updated based on the most relevant facts. Constraining events might include situations giving rise to a reversal of revenue such as a history of unsuccessful projects with a particular customer.
- **Significant financing component**: A time value of money impact should be accounted for in the estimate.
- **Noncash consideration**: If the customer is not paying cash for the goods or services provided, the goods or services should be measured at fair value.
- **Consideration payable to a customer**: Revenue recognized should be reduced by that amount.

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4. Allocate the Transaction Price

If the contract includes separate performance obligations, revenue should be recognized as each is completed. You also must consider discounts. If a discount relates to only one or a few (but not all) specific contract items, then the discount should be allocated to reduce the transaction price of that performance obligation and reduce revenue related to that performance obligation. However, a general discount should be allocated proportionately as revenue is recognized. A similar rule should be followed for variable consideration.

5. Recognize Revenue When (or as) Performance Obligations Are Satisfied

Under ASC Topic 606, revenue is recognized when transfer of control occurs. If the entity transfers control of a good or service over time, then revenue should be recognized over time.

So how do we begin to think about whether these rules will impact our clients? Consider our client's business model and industry. Understanding the economic rewards and consequences of common transactions in specific industries is a good place to start. A broad understanding of how our clients generate sustainable profits is a solid foundation for navigating through the five-step process. This is also the approach the AICPA has taken in preparing its recently released *Audit and Accounting Guide: Revenue Recognition*.

Now that we have an idea what needs to be done, we need to understand the transition rules.

Transition

While it seems like the implementation date provides companies with plenty of time to determine whether and what changes will be required, the effective date of the new standard is relatively soon, i.e. 2019 for calendar year-end private companies.

But for entities, choosing the appropriate transition methods will require much earlier consideration of what the standard means. Under the full retrospective method, private entities may need to restate one comparative year prior to the implementation date. Companies also may choose to take advantage of numerous practical expedients, including one that permits them to not restate contracts that begin and end within the same annual reporting period for contracts completed before the date of initial application.

Under an alternative method, the new standard applies only to contracts that are not completed under legacy IFRS or U.S. GAAP at the date of initial application. Entities would recognize the cumulative effect of initially applying the new standard as an adjustment to the opening balance of retained earnings in the year of initial application. Comparative years would not be restated, but some detailed additional disclosures would be required.

Each transition option has pros and cons. Companies may want to consider both options, but won't be able to do that without a focused, thorough effort that must start soon.

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Small CPA Firm Clients

Many small firms do not have the resources to efficiently and effectively tackle this problem. Our guess is implementations work something like trickle-down economics. While leaders in significant industries may update contract wording to achieve the desired accounting outcome, this might not occur in time to alleviate stressful and expensive accounting changes. CPA firms may need to issue or report on financial statements with a combination of notes, disclosures, emphasis of matter opinions or GAAP departures resulting from the client's inability to navigate the changes.

Some situations may be preventative in nature since "we don't know what we don't know." For many small firms the question is: Will the client pay for us to review all their contracts and determine how to apply the rules?

For clients whose revenues exceed a threshold, say $10 million, for example, this may be another matter. In these cases you will need to get the top financial officer to review the new revenue recognition rules and determine the effect on the client, and then you will need to review or audit that analysis.

Since the implementation dates are close, implementation of revenue recognition, leasing and new credit rules is effectively all occurring at once. Will this effort be so daunting that it will drive clients to an alternative basis of accounting or reporting?

WHAT ASC TOPIC 606 MEANS FOR...

The Asset Management & Real Estate Industries

Implementation in the real estate industry is expected to be challenging due to issues involved with determining whether or not a contract exists, identifying the customer and calculating the amount of variable consideration to be recognized. Some of the specific issues include:

- **Identifying the Customer:** This question involved considerations needed when assessing whether or not a contract exists between an asset manager and customer, and identifying the customer (i.e. the investor or the fund). **Status**: Finalized (included in the 2017 AICPA *Audit and Accounting Guide: Revenue Recognition*).
- **Management Fee Revenues, Fee Waivers, Fund Expense Reimbursements:** This issue involves when and how to recognize revenue from management fees—including unitary fees, fee waivers and customer expense reimbursements. Complexities involve identifying and analyzing separate performance obligations within the management fees. **Status**: On June 1, 2017, the task force issued a comprehensive working draft: *Asset Management Revenue Recognition Implementation Issue for Management Fee Revenue Excluding Performance Fee Revenue*.
- **Costs of Managing Investment Companies:** This implementation issue discusses how asset managers should account for the costs related to managing an investment company. **Status**: Out for exposure.
- **Incentive or Performance Fee Revenues (excluding carried interest):** This issue concerns how and when incentive or performance revenue, excluding carried interest, should be recognized under the new standard **Status**: On June 1, 2017, the task force issued a comprehensive working draft: *Asset Management Revenue Recognition Implementation Issue for Incentive or Performance Fee Revenue, Excluding Incentive-based Capital Allocations* (such as carried interest).
- **Incentive-Based Capital Allocations:** This implementation issue raises the question of whether incentive-based capital allocations, such as carried interest, fall within the scope of FASB ASC Topic 606 or FASB ASC Topic 323, *Investments—Equity Method and Joint Ventures*. **Status**: Out for exposure.
- **Recognition of Contingent Deferred Sales Charges:** This issue evaluates the criteria used to recognize revenue from such charges under the new guidance, including the identification of separate performance obligations and variable consideration. **Status:** Finalized (included in the 2017 AICPA *Audit and Accounting Guide: Revenue Recognition*).

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Alternatives

In 2013 the AICPA issued its *Financial Reporting Framework for Small- and Medium-Sized Entities* (FRF for SMEs). This is a non-GAAP alternative basis of accounting joining other available comprehensive bases of accounting such as tax and cash method. These alternatives propose simplified reporting and accounting for:

- Taxes;
- Variable interest entities;
- Goodwill; and,
- Revenue recognition and leasing.

Will smaller clients that don't already report on non-GAAP methods make the change?

And as discussed earlier, another choice is to use a "GAAP-with-exceptions" type of hybrid accounting, requiring explanations and possibly qualifications in the Accountants' or Auditors' Report.

> Many **small firms** do not have the resources to efficiently and effectively tackle this problem.

Tax Consequences

Taxes are yet another matter. If revenue has been reported for tax purposes using a particular method, a change for book purposes may prompt you or your client to request a corresponding method change from the IRS. Until effective, there could be an M-1 adjustment (timing difference) requiring additional record keeping. So you may have to calculate revenues two ways. How very nice for us!

So the effects of implementation could be muddled and confusing. Clients will fully transition on different timetables and in different ways. Some will stay with alternative accounting, while others will go to the new rules. You will need to pay close attention during this period as things become clearer. What you don't want is for your peer reviewer to ask you how you implemented revenue recognition and stare back at them like a deer in the headlights.

Industry Changes: What Are the Pit Falls?

Let's be clear, this is a big project. It will take years for all the questions to be answered. But with the effective date fast approaching, entities operating in many industries need to consider all developments.

One way to do this is to follow guidance issued by the FASB's Joint Transition Resource Group for Revenue Recognition (TRG). You can find the TRG under the "standards" tab at www.fasb.org/home. Since ASC Topic 606 was issued, the TRG has been working to solicit,

WHAT ASC TOPIC 606 MEANS FOR...

The Health Care Industry

- **Self-Pay Customers:** Health care entities will have issues around self-pay customers—including how to apply the portfolio approach to contracts, the identification of contracts and evaluation of whether a contract exists and the determination of the transaction price. There also are expected to be issues dealing with price concessions. **Status**: The price concession questions were submitted to the TRG while the other issues are finalized and included in the 2017 AICPA *Audit and Accounting Guide: Revenue Recognition.*
- **Continuing Care Retirement Community (CCRC):** Implementation issues here include how a CCRC will estimate the transaction price and recognize nonrefundable entrance fees as well as monthly/periodic fees received from residents. The task force also expects to provide guidance on how CCRCs assess whether a significant financing component exists when determining the transactions price. Lastly the task force is addressing and expects to describe the changes to a CCRC's calculation of the obligation to provide future services and use of facilities, also referred to as the future service obligation. **Status**: The task force has not yet been able to provide guidance and has referred back to the AICPA's Revenue Recognition Working Group.
- **Accounting for Contract Costs:** This implementation issue will discuss how health care organizations will account for certain costs of acquiring and fulfilling contracts under the new model. **Status**: Submitted to the Financial Reporting Executive Committee in September 2015.
- **Third-Party Settlement Estimates:** This issue involves accounting for revenue earned under arrangements with government programs (for example, Medicare or Medicaid), which typically contain a variable element requiring providers to estimate the cash flows ultimately expected to be received for services provided. Under the current standard, entities make their best estimate of amounts due to or from third-party payors. Under the new standard, they are required to consistently use the most likely amount, or expected value amount, applying this constraint consistently to similar forms of variable consideration. **Status**: Out for exposure.
- **Disclosure Requirements:** Disclosure requirements under the new standard are expected to exceed GAAP. This issue involves judgments related to these new disclosure requirements, including presentation of bad debts and information about an entity's contracts with customers. Disclosures include disaggregation of revenue, information about asset and liability balances and information about an entity's performance obligations. **Status:** Out for exposure.

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analyze and discuss issues that arise as organizations prepare to implement the standard.

To ensure that all stakeholders have an opportunity to learn about the new standard from others involved with implementation, TRG members were selected to represent a wide spectrum of industries, public and private organizations, and perspectives (financial statement preparers, auditors, and users).

The TRG has met several times and discussed more than 55 implementation issues. The discussions have helped to inform the FASB about a few areas for which clarifications or practical expedients would be helpful. In response to that feedback, the FASB has made improvements that are expected to increase consistent application of the standard by reducing cost and complexity both at implementation and on an ongoing basis.

For example, *Accounting Standards Update No. 2016-08* (ASU 2016-08) issued in March 2016 clarified the guidance in determining whether an organization is a principal or an agent. In April 2016, FASB clarified the guidance on identifying performance obligations and licensing by issuing *Accounting Standards Update No. 2016-10* (ASU 2016-10). Finally, *Accounting Standards Update No. 2016-12* (ASU 2016-12), issued in May 2016, addressed challenges related to collectibility, noncash consideration, contract modifications and the presentation of sales taxes.

Entities also will want to monitor developments of the 16 industry task forces formed by the AICPA to address implementation issues and help develop a new *Audit and Accounting Guide: Revenue Recognition*. The guide includes general accounting and auditing information to be considered when implementing the new standard as well as industry-specific considerations. You can monitor activities of the industry task forces by scrolling through the interest areas tab on the AICPA website to reach the Financial Reporting Center, which contains a further link to the revenue recognition area.

We've highlighted in the sidebars a sample of questions identified by the task forces for a few of the industries impacted. While these are not all of the issues you may come upon and represent only four of the 16 industry task forces, they embody some of the areas where the AICPA is putting forth effort to provide guidance. As things change you will have to keep your wits about you. The guidance available in 2017 might be less substantial that that available in 2020. Good luck! CPA

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